



Strange Days

If you like watching paint dry, or grass grow, this has been your kind of market. For everyone else, it's been somewhat uninspiring. Even a tragic terrorist attack in London wasn't enough to shake up the status quo. Fortunately, at GeoVest, our primary focus is on the true, underlying economics of the world markets and less on near term market action.

If you enjoy looking closely at economic and corporate data, this is a fantastic time to follow the markets. Take the bond market. For the first time ever, 10 year US Treasury rates have fallen while the Federal Reserve is raising interest rates (more on that later). In the stock market, stock prices have fallen, yet corporate earnings continue to rise. In the currency markets, the dollar has rallied aggressively this year, as we predicted, despite a horrendous trade imbalance. All of these strange situations have been enough to send a shiver through the hedge fund community as some of the funds are posting very large losses.

Volatility which measures the movement of stock prices hasn't been this low in a decade. Notice the chart we've provided that shows the VIX, or volatility index. As the index falls, it's telling us that stock prices are not moving around a lot. This means that buy and sell prices are not being hit, which explains the extended holding period for some of our stocks.



Taking this lack of volatility into consideration, we're going to slightly modify our buy and sell disciplines to benefit from this period of low volatility in the market. Our base discipline is to purchase securities that are deeply below intrinsic value and sell them when they are clearly overvalued. You can see from the chart we've provided that we look to buy stocks when they fall into the green zone – the deeper into it the better – and to sell them in the red zone.

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GeoVest's Pricing Discipline



We look to buy when the stock is in the green range and sell when the stock is in the red range.

Given low volatility and that markets continue to remain at high levels, we're not finding many stocks in the green zone, therefore, our slight adjustment is to buy stocks around their intrinsic value, where green meets red, and sell them after they've experienced more modest gains – 15% to 20%. This will lead to more trading in your accounts, but hopefully stronger returns. Normally I equate portfolio turnover with insufficient analysis, but sometimes you have to bow to the realities of the moment and make small adjustments to your disciplines.

The Stock Market

We're having a pretty good year, despite the need for small changes. Most of our accounts are up between 2% and 4% for the first six months of the year compared to the S&P 500's 1.7% loss, and 5% losses for both the Dow Jones Industrial Average and the Nasdaq Composite. Still, I think we can do better and I hope these minor changes will give us enough boost to get the equity accounts up close to 10% for the year. This would bring us close to our goal of compounding equity growth at 10% a year or better.



We're not satisfied with the results but to be perfectly frank, we expected the market and the economy to weaken before this time. The absence of a market correction has kept us from getting more aggressive in your portfolios since the prices of stocks have not fallen to our buying levels. Rather than sitting tight, we've opted to adjust our strategies so that we can achieve our short term goals until the market moves back in our favor.

As I've mentioned before, the stock market essentially mirrors the economy in the US and this lackluster performance of the stock market defies the terrific data that keeps coming out about our economy. We started with our "Hollywood Recovery" theme in our January 2004 newsletter because we didn't believe all the hype concerning our robust economy, and we've largely been right. It's why we've chosen a conservative investment strategy for our client's accounts and it's why we have introduced hedging instruments into most of those accounts.

I don't mean to give you the impression that we are going to be permanently in a conservative investment mode.

Economies and markets change and our strategies will change along the way. A year from now, I hope to be telling you about some great new investment ideas that we expect to greatly enrich your portfolios, but for now, we will remain conservative and vigilant.

The Economy

I love studying economics but that puts me in the minority, which is why I try to describe our economic climate in a form that everyone can follow. Think of your street as a microcosm of the US economy. You've got neighbors that have gotten new jobs or promotions as well as neighbors that have lost their jobs. Some people therefore are adding to their spending while others are cutting back on purchases. When you compile everyone's

spending for a given year, you get a rough approximation of GDP or gross domestic product. GDP is the measure of our nation's economic output.

Given that GDP essentially measures final sales, it merely shows one part of the economic story. For GeoVest, we are more concerned with how the economy achieved its growth and whether that growth is sustainable. For example, what if all your neighbors increased their debt level dramatically so they could purchase consumer goods like cars as well as upgrading their homes? On the surface, it would look like someone struck a vein of gold and the GDP of your street would rise strongly. But we all know that debt has a common characteristic; it eventually has to be paid back and without an increase in incomes, debt has to be paid back by reducing future consumption.

Returning to your street, on average, your neighbor's incomes have not risen since the year 2000, yet their driveways are filled with new cars and their homes have new siding. Unless they start to see a rapid increase in their incomes, they're going to eventually have to cut back on all that consumption. But as we have discovered, it's difficult to push for higher incomes if someone in Asia can perform your job more cheaply.

In a nutshell, that's the US and European economies. Sure you can point to the rising values of homes as an offset to weak incomes but if you do the math, you'll find that in total we're not better off. For someone to experience a gain by selling their home, someone else has to assume a bigger mortgage, which ultimately has to be paid off. That means without a rise in incomes or a drop in interest rates, today's buyers are going to have to cut back on spending further to make the larger payments.

The Bond Market

As mentioned in our last newsletter, this is a story of two different markets – short term interest rates and long term interest rates. The Federal Reserve essentially controls short term interest rates and you can see from the picture that these rates continue to move up.



The second market is long term interest rates and they have actually fallen. While this seems insignificant, it's actually very important. Long term interest rates have never fallen when the Fed has raised short term interest rates. The Fed normally raises interest rates to slow an economy that is expanding too quickly and is a threat to cause inflation. Since inflation is generally rising, long term bond investors demand a higher rate of return to compensate them for the higher inflation because inflation takes away from bond returns. The fact that long term interest rates have actually fallen is a red flag that something is potentially wrong with our economy.



GeoVest's clients should not be surprised by this because for the past 18 months, we've been talking about the transient nature of our economic recovery. If anything, this recent action suggests that we are on the right track with our current investment gameplan.

Further justification comes when you tie these two markets together in what is called the yield curve. The yield curve is nothing more than the corresponding US Treasury rate for maturities between 1 month and 20 years. As you can see from the graph provided, the yield curve has flattened over the past 18 months. This means that short term interest rates roughly match long term interest rates. Historically, a flat yield curve has been a terrific predictor of future economic weakness.



Going forward, we continue to expect the Federal Reserve to raise short term interest rates until it becomes more obvious that our economy is weakening. Then we expect them to abruptly stop. We also expect long term interest rates to stabilize at current levels, and perhaps move back up a little.

In regards to credit quality, many of you may have noticed that we have been buying US Treasuries in our tax-free accounts when we purchased US Agencies like Fannie Mae and Freddie Mac in the past. There are two important reasons. The first is that the returns offered over the corresponding Treasury

bonds are negligible - we're not getting paid for the added risk. Secondly, neither of these two agencies has filed a financial report with the SEC in a year or more. It doesn't take an accounting degree to determine that if they are not filing financial reports, they have problems.

The GeoVest Approach

Uncertainty continues in the markets and we plan to use that uncertainty to find opportunities to expand our client's wealth. It may take some patience to see the wisdom of our strategies, but we are confident that patience will be rewarded. Thank you and it is our pleasure to manage your money.

Philip M. Byrne, CFA
Chief Investment Officer

Some Recent Changes

It is our great pleasure to introduce Nancy Wagner as our new Assistant Vice President and Manager of Operations. We are very fortunate to have an individual of Nancy's quality and experience at GeoVest and we look forward to the many ways that she can improve the service we offer to clients.

Also, our new website is up and running and we urge you to check it out at www.geovestadvisors.com. Besides a description of the firm and our strategies, you will be able to see our latest updates on the economy and the markets.

